



Balancing growth across geographic diversification and product diversification: A contingency approach

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ABSTRACT

We theorize that firms simultaneously seek to balance their growth across both the geographic and product diversification domains. To achieve this balance, businesses commonly adopt a strategy of expanding an under-diversified direction at the expense of an over-diversified one. Accordingly, we depict geographic diversification and product diversification as being an endogenous relationship, from which we hypothesize that firms that have under-diversified in a given direction and over-diversified in the other will expand the former at the expense of the latter. Meanwhile, firms that have under-diversified in both directions will expand both diversification paths, while firms that have over-diversified in both directions will contract in both diversification routes. We investigate these predicted relationships and show them empirically using a sample of leading Japanese multinationals in the 1990–2000 period.

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1. Introduction

Geographic diversification and product diversification have long been acknowledged as two dominant growth strategies of firms (Caves, 1996; Mudambi & Mudambi, 2002). The ability to introduce multiple products to multiple countries can increase sales and reduce operating costs provided a firm does not over expand (Geringer, Tallman, & Olsen, 2000). Although both the separate and joint impact of geographic and product diversification on firm performance have been extensively researched (Delios & Beamish, 1999; Geringer, Beamish, & DaCosta, 1989; Hitt, Hoskisson, & Kim, 1997; Tallman & Li, 1996), relatively little attention has been given to the inter-relationships between these two growth strategies (Peng & Delios, 2006). The few studies that have considered this relationship found contradictory relationships between geographic and product diversification, including: a positive linear relationship indicating complementarity between the two strategies, a negative linear relationship indicating a substitution effect between these two growth strategies, and more complex curvilinear relationships (e.g. Davies, Rondi, & Sembenelli, 2001; Kumar, 2009; Meyer, 2006; Pearce, 1993; Wiersema & Bowen, 2008; Wolf, 1977). Hence, the exact nature of the relationships between geographic diversification and product diversification remains vague and unclear, in both a conceptual and an empirical sense.

We address these issues by developing a conceptual perspective on the relationship between geographic and product diversification that takes into account the current levels of both types of diversification when predicting future levels of these two types of diversification. We ground our arguments in the Resource Based View (RBV) and Transaction Costs Economics

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(TCE) to contend that firms seek to increase diversification and growth in underutilized directions while trying to avoid over-diversification in specific paths. In this sense, we regard a firm's growth as an attempt to balance the two diversification dimensions.

Specifically, we hypothesize that firms with low geographic and product diversification levels will increase both types of diversification. However, firms with low product diversification and high geographic diversification will increase the former and reduce the latter, while firms with high product diversification and low geographic diversification will reduce the former and increase the latter. Finally, firms with high levels of both geographic diversification and product diversification will reduce both types of diversification. This view offers an important contingency to our understanding of the relationships between geographic and product diversification as it implies that such relationships will differ for firms at different levels of both diversification types.

We test these predictions on panel data of 288 Japanese multinational corporations (MNCs) covering the years 1990–2000. During the last two decades of the 20th century, Japanese firms went through a period of rapid geographic expansion and also expanded product-wise, which allows us to capture the longitudinal profile of Japanese firms at varying stages of geographic diversification and with a good range in their level of product diversification.

Two important features of our empirical estimation method are noteworthy. First, the methodology involves separating the firms in our sample into four different quadrants representing their respective levels of geographic and product diversification as a means of distinguishing between firms that are under-diversified and over diversified in terms of geographic and product diversification. Secondly, the methodology corrects for the fact that geographic and product diversification decisions are likely to be made *simultaneously and endogenously* by running Two Stage Least Squares (2SLS) within-firm fixed effects regression models.

The rest of the paper is organized as follows. In Section 2 we present our conceptual framework. In Section 3 we describe our data and estimation methods and forwarding Section 4 we discuss our results. In Section 5 some preliminary performance implications of our study are drawn and finally in Section 6 we discuss our results and future research directions, and draw relevant conclusions.

2. Background literature and hypothesis development

2.1. *The limits of diversification*

Numerous studies have examined the collective impact of both product diversification and geographic diversification on the performance of firms (e.g. Hitt, Hoskisson, & Ireland, 1994; Hitt et al., 1997; Palich, Carini, & Seaman, 2000; Tallman & Li, 1996). However, only a few studies have investigated the direct relationship between product diversification and geographic diversification (Davies et al., 2001; Kumar, 2009; Meyer, 2006; Pearce, 1993; Wiersema & Bowen, 2008). These streams of research build on the view that there are limits to the positive performance implications of product diversification (e.g. Amit & Livant, 1988; Grant, Jammine, & Thomas, 1988; Lubatkin & Rogers, 1989; Palich, Cardinal, & Miller, 2000; Robins & Wiersema, 1995; Simmonds, 1990) and geographic diversification (Contractor, Sundu, & Hsu, 2003; Geringer et al., 1989; Gomes & Ramaswamy, 1999; Lu & Beamish, 2004; Sullivan, 1994).

Although both types of diversification allow for synergy exploitation and gains of economies of scale and scope (Caves, 1996; Dunning, 2000; Farjoun, 1994; Kogut, 1985; Montgomery & Wernerfelt, 1988; Teece, 1982) that lead to better returns, such expansion also incurs heightened transaction and coordination costs after a certain level of diversification has been reached (Bartlett & Ghoshal, 1989; Gomes & Ramaswamy, 1999; Hill & Hoskisson, 1987; Jones & Hill, 1988; Lu & Beamish, 2004; Montgomery & Wernerfelt, 1988). The limitations of both geographic and product diversification to enhance performance are also defined by the limits of the managerial capacity to cope with the increased complexity of a highly diversified firm (Grant, 1987; Hitt et al., 1994). Building on these views of the costs and benefits of geographic and product diversification (Lu & Beamish, 2004; Palich, Cardinal, et al., 2000; Palich, Carini, et al., 2000), scholars have developed arguments that suggest that these two strategies can complement or substitute for each other.

2.2. *Arguments for complementarity between geographic and product diversification*

Davies et al. (2001) claim that for differentiated products, geographic diversification and product diversification are complementary strategies that enable a firm to maximize its utilization of a firm's proprietary assets. Adopting an RBV approach, their view assumes that the same firm-specific proprietary assets may foster both types of diversification. Likewise, Delios and Beamish (1999) note that for highly diversified Japanese firms, geographic and product diversification complement each other, as the need for assets to enter distant lines of business can be met by the opportunities found to generate or acquire new assets when expanding the firm's geographic scope. This view is also supported by Kim, Hwang, and Burgers (1993), who argue that increased geographic diversification enables firms to reduce the risk of and increase returns from product diversification, since additional market opportunities are opened for product diversified firms that pursue geographic expansion. Meanwhile, Geringer et al. (2000) show that geographic and product diversification complement each other by permitting a firm to leverage its strategic rent-yielding resources from existing operations in order to increase its rents. Finally, Hitt et al. (1994, 1997) argue that the combination of high levels of geographic and product diversification creates synergies that enable firms to differentiate their products while incurring lower costs than non-diversified firms.

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